

## Desperate Central Bankers

---

Stephen Roach | Yale University | 27 September 2016

The final day of the summer marked the start of yet another season of futile policymaking by two of the world's major central banks – the US Federal Reserve and the Bank of Japan. The Fed did nothing, which is precisely the problem. And the alchemists at the BOJ unveiled yet another feeble unconventional policy gambit.

Both the Fed and the BOJ are pursuing strategies that are woefully disconnected from the economies they have been entrusted to manage. Moreover, their latest actions reinforce a deepening commitment to an increasingly insidious transmission mechanism between monetary policy, financial markets, and asset-dependent economies. This approach led to the meltdown of 2008–2009 and it could well sow the seeds of another crisis in the years ahead.

Lost in the debate over the efficacy of the new and powerful tools that central bankers have added to their arsenal is the harsh reality of anemic economic growth. Japan is an obvious case in point. Stuck in what has been essentially a 1% growth trajectory for the last quarter-century, its economy has failed to respond to repeated efforts at extraordinary monetary stimulus.

Whatever the acronym – first, ZIRP (the zero interest-rate policy of the late 1990s), then QQE (the qualitative and quantitative easing launched by BOJ Governor Haruhiko Kuroda in 2013), and now NIRP (the recent move to a negative interest-rate policy) – the BOJ has over-promised and under-delivered. In fact, with Japan's real annual GDP growth slipping to 0.6% since Shinzo Abe was elected Prime Minister in late 2012 – one-third slower than the sluggish 0.9% average annual rate over the preceding 22 lost years (1991 to 2012) – the so-called maximum stimulus of "Abenomics" has been an abject failure.

The Fed hasn't fared much better. Real GDP growth in the US has averaged only 2.1% in the 28 quarters since the Great Recession ended in the third quarter of 2009 – barely half the 4% average pace in comparable periods of earlier upturns.

As in Japan, America's subpar recovery has been largely unresponsive to the Fed's aggressive strain of unconventional stimulus – zero interest rates, three doses of balance-sheet expansion (QE1, QE2, and QE3), and a yield curve twist operation that seems to be the antecedent of the BOJ's latest move. (The BOJ has just announced that it is targeting zero interest rates for 10-year Japanese government bonds.)

Notwithstanding the persistent growth shortfall, central bankers remain steadfast that their approach is working, by delivering what they call "mandate-compliant" outcomes. The Fed

points to the sharp reduction of the US unemployment rate, from 10% in October 2009 to 4.9% today, as *prima facie* evidence of an economy that is nearing one of the targets of the Fed's so-called dual mandate.

But when seemingly solid employment growth is juxtaposed against weak output, the story unravels, revealing a major productivity slowdown that raises serious questions about America's long-term growth potential and an eventual buildup of cost and inflationary pressures. The Fed can't be faulted for trying, argue the counter-factualists who insist that only unconventional monetary policies stood between the Great Recession and another Great Depression. That, however, is more an assertion than a verifiable conclusion.

While policy traction has been notably absent in the real economies of both Japan and the US, asset markets are a different story. Equities and bonds have soared on the back of monetary policies that have led to rock-bottom interest rates and massive liquidity injections.

The new unconventional monetary policies in both countries are obviously missing the disconnect between asset markets and real economic activity. This reflects the aftermath of wrenching balance-sheet recessions, in which aggregate demand, artificially propped up by asset-price bubbles, collapsed when the bubbles burst, leading to chronic impairment of overleveraged, asset-dependent consumers (America) and businesses (Japan). Under such circumstances, the lack of response at the zero bound of policy interest rates is hardly surprising. In fact, it is strikingly reminiscent of the so-called liquidity trap of the 1930s, when central banks were also "pushing on a string."

What is particularly disconcerting is that central bankers remain largely in denial in the face of this painful reality check. As the BOJ's latest actions indicate, the penchant for financial engineering remains unabated. And as the Fed has shown once again, the ever-elusive normalisation of policy interest rates continues to be put off for yet another day. Having depleted their traditional arsenal long ago, central bankers remain myopically focused on devising new tools, rather than owning up to the destructive role their old tools played in sparking the crisis.

While financial markets love any form of monetary accommodation, there can be no mistaking its dark side. Asset prices are being manipulated across the board – stocks and bonds, long- and short-duration assets, as well as currencies. As a result, savers are being punished, the cost of capital is repressed, and reckless risk taking is being encouraged in an income-constrained climate. This is especially treacherous terrain for economies desperately in need of productivity-enhancing investment. And it is not dissimilar to the environment of asset-based excess that incubated the 2008–2009 Global Financial Crisis.

Moreover, frothy asset markets in an era of extreme monetary accommodation take the pressure off fiscal authorities to act. Failing to heed one of the most powerful (yes, Keynesian) lessons of the 1930s – that fiscal policy is the only way out of a liquidity trap –

could be the greatest tragedy of all. Central bankers desperately want the public to believe that they know what they are doing. Nothing could be further from the truth.

(c) Project Syndicate

---



*Stephen S. Roach, former Chairman of Morgan Stanley Asia and the firm's chief economist, is a senior fellow at Yale University's Jackson Institute of Global Affairs and a senior lecturer at Yale's School of Management. He is the author of *The Next Asia* and *Unbalanced: The Codependency of America and China*.*

---